RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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February 9, 1983 **LETTER 854**

Jan. 28, DJIA 1064.75; PTI 1467; A-D ratio –18.31
Feb. 4, DJIA 1077.91; PTI 1485; A-D ratio –17.89

THE MARKET: A lot of people use a lot of gimmicks in an attempt to "predict" the market. One is the outcome of the Superbowl. For instance, if an original NFL team wins the Superbowl, the market, historically, will enjoy a bull year. The Redskins were an original NFL team so 1983 should be a good one. Another gimmick is the "January barometer." As January goes, states this study, so goes the whole year. For the record the Dow was up 2.8% for January, the S & P Composite was up 3.3% and the NYSE was up 3.4% while Value Line's Composite was up 4.6%. On both counts, the market "should be" up in 1983. It should only be that easy!

The stock market, since August, 1982 has presented us with four major lessons. Lesson 1: The market has its own wisdom, and it can move completely opposite to the obvious fundamentals. In August, 1982, the fundamentals for the economy, the international picture and for corporate earnings looked terrible. And I'm not sure things have changed that much since late-1982 (except in the interest rate sector). But the market, despite this, surged to record highs.

Lesson 2: The technical picture can be confusing and even deceptive. For instance, the negative volume index never got substantially off its low during the entire August-January rise. Again, the daily new high index for the NYSE topped out in October, but this did not stop the market's rise. Again, the advance-decline line was a laggard, only catching up to the Dow over the last month or so. But the market remained strong.

Lesson 3 (this pertains to me and my subscribers): The PTI can be extremely valuable in situations where the technicals are confusing or at odds with each other. The rule, "stay on the right side of the PTI", was amply demonstrated during August to January.

Lesson 4: A *diversified* portfolio may not be the perfect place to be during a bull move, but a diversified portfolio is guaranteed to capture a good chunk of any rise. No-load funds provide the diversification necessary, and those who were in no-load funds saw their capital appreciate substantially during August to January. On the other hand, those who were in oil and energy stocks, in most cases, actually lost money during the same period–despite the fact that all the major averages rose to record highs.

* *

The news event of the past few weeks was Mr. Reagan's grisly 1984 budget. The budget contained a planned deficit of $188.8 billion for 1984, and that would follow this year's (1983) budget deficit of $207.7 billion. The fact that the President can even propose this kind of disastrous deficit indicates that the nation has now moved into the realms of fiscal insanity.

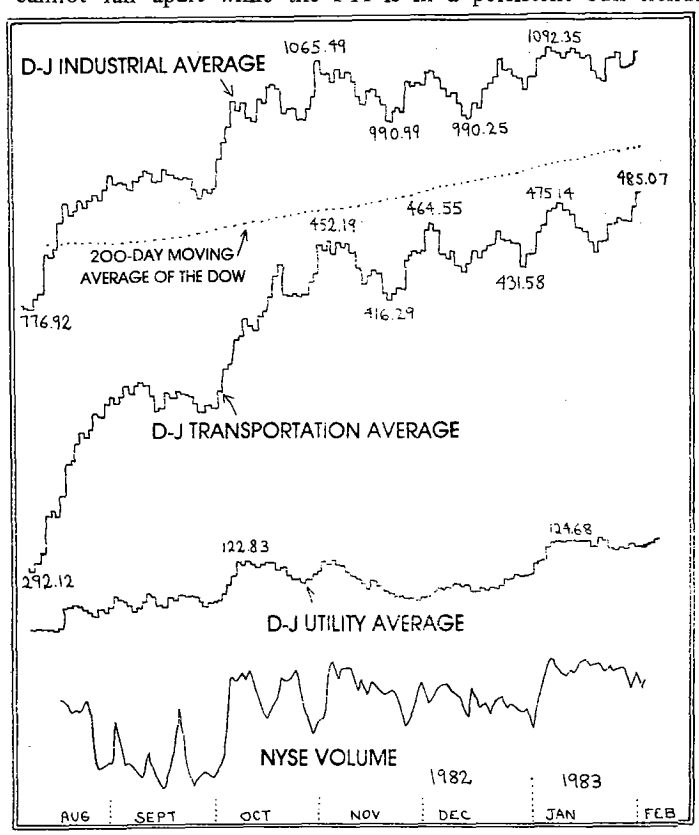
The technical event of the past few weeks was gold's reaction to the budget–a rise in the spot price to over 500. Thus gold pushed into the top half of the 0-500-1000 equation.

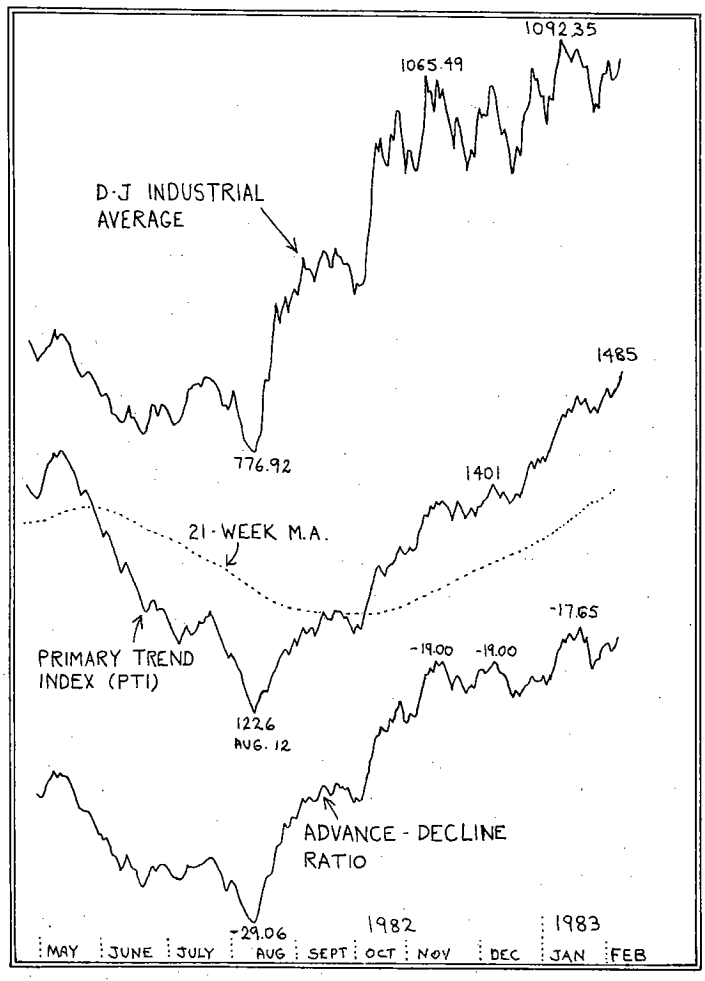
Meanwhile, the stock market continues to fluctuate within its broad trading range, a range bordered by 1092.35 (Industrials) and 475.14 (Transports) on the upside, and 990.25 and 416.29 on the downside. The most bullish thing about the stock market is the almost unanimous opinion that a correction is imminent. The most bearish thing about the stock market is that upside momentum has ebbed, and daily new highs have sunk far below late-1982 levels.

FRONT PAGE COMMENT: The great paradox of the 1980's is becoming apparent. Here it is: from every quarter we hear about deficits and money shortfalls. There's an international shortage of cash. There are shortages at the US Treasury, there are deficits at the state treasuries, the municipalities, the cities. Moreover, corporate liquidity is still near historic lows. Everybody NEEDS CASH. So what's the paradox? The paradox is that nobody trusts cash–despite the need for it. The dollar, as legal tender, is needed everywhere. But the dollar as a store of value is suspect.

So what do you do–accumulate dollars or get rid of them? And if you are lucky enough to be accumulating dollars, where do you put them? My answer: diversify. Spread 'em around. There's no ultimate answer anymore. In diversity, you simply spread the risk.

The Primary Trend Index (PTI) has acted considerably stronger than the Dow since last October (see page 2 chart). Therefore, if any potential weakness was hidden in the laggard performance of the Dow, that weakness was held in abeyance by the steady rise in the PTI. As I've said so many times before, the market cannot fall apart while the PTI is in a persistent bull trend.





On January 31 the PTI recorded a recovery high value of 1473. This high was not confirmed by either the Dow or the A-D ratio. Whether this is the beginning of trouble remains to be seen. I have drawn a rising trendline under the PTI, a trendline that connects the August, October and December lows. The PTI is currently 16 points *above* this trendline.

I feel that this is a valid and important trendline. Why do I attach such significance to the trendline? (1) Because it is a fairly shallow trendline, and a strong PTI can be expected to hold easily above it. (2) Because it has been in force for five months, long enough to make this trendline significant. (3) Because the trendline has been tested twice at fairly wide intervals.

Below the PTI we see the A-D ratio (this is a proxy for all the stocks on the NYSE). The A-D ratio has lost a good deal of its upward momentum. In fact, the A-D is now only slightly above its November peak. Thus, the A-D ratio has stayed pretty much in step with the Dow. It almost seems as if the strength in the PTI has been single-handedly holding this market up (see Late Notes).

INVESTMENT POSITION: The bull stays in this box as long as the trend of the PTI is up. As of this writing, it is. I have been recommending holding no-load stock funds, and these funds should be retained as long as the Averages remain bullish, and as long as the PTI holds above its rising trendline and above its 21-week moving average.

Gold related items (gold coins, ASA, Campbell Red Lake) should be held up to 25% of assets. I think that gold certificates from reputable brokerage houses are all right to hold. A gold certificate is a buy slip which states that you own a certain amount of gold bullion. This bullion should be held at a bank for safekeeping and it should be insured. The commission for such transactions is low, usually around 1%. The only "safer" way of holding gold is in coin form in some secret hiding place or in your bank vault (but even here there is not perfection, since there is no ideal hiding place, and banks have had their vaults "blown" by daring burglars).

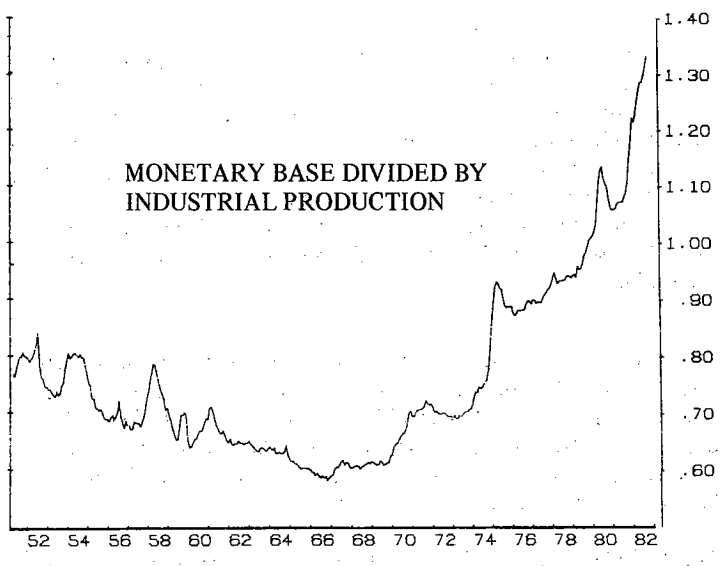
A few of the no-load funds that I like are Guardian (run by Neuberger, Berman), (212) 850-8300. Lindner Fund (314) 727-5305. Value Line Income Fund (800) 223-0818.

QUESTIONS &ANSWERS: *Question:* Russell, what is your view of the oil situation and OPEC?

Answer: We're facing a situation (ironically) where the US is all for holding oil prices at a high level. The banks have lent huge sums of money both to private corporations and to oil producing nations–loans based on rising oil prices. If the oil price cracks badly, the banks are going to have major problems. On top of that, the US depends on oil taxes (so called "excess profits" tax) for huge chunks of tax income. If oil prices crack then the profits for the oil companies will dive (which they are already doing) and the tax short-fall will be horrendous.

Question: Russell, what are your current views on inflation–or deflation?

Answer: The US and the world have a problem. They've spent the future in order to "be happy" in the present. This process of consistently spending more that your income has brought on inflation. Since 1966 the inflationary process has accelerated. This chart (courtesy of Kidder Peabody) shows the monetary base for the US divided by the industrial production figures. Note that the ratio is now rising at an exponential rate. In other words, it is taking more and more money to produce less and less in the way of industrial production.



This kind of parabolic rise always ends with a bust. What bothers me is that I think we're approaching a situation wherein the Fed will hesitate to provide enough upside acceleration in the monetary base to keep industrial production rising. This leads to

my thesis that "not enough inflation in a high-debt economy is deflationary." I think we're seeing that now. The fact is that the Fed is pumping, but the economy has been surprisingly resistant to "coming back." Whether the economy does come back in any meaningful way remains to be seen.

Question: If your view is correct, if we're in a period of long-term disinflation or deflation, how can you justify holding anything but cash?

Answer: To be honest, it's rather difficult. In the shorter term, the argument for holding stocks is that a low rate of inflation will be bullish for stocks.

But that argument was never used in a situation like the current one–a situation in which corporations are loaded with debt. Whether these corporations can survive with debt-ridden structure during a period of deflation remains to be seen.

As far as precious metals and commodities, a decline in inflation would obviously be bearish for them. But we're in strange and exotic times, and we must remember that governments are not going to take deflation lying down (note how the US is even trying to keep the price of oil up). The Fed has obviously been trying to reflate, trying to pump up the economy again. But my own feeling is that the deflationary forces of the debt may be too much for the Fed (or it may require more pumping of the money supply than the Fed is willing to do). Thus, at some juncture the Fed may give up trying to manipulate the natural forces of deflation and simply let the storm run. In that case, we could have terrible scares regarding the banking system, and this would be bullish for gold.

Suffice it to say that events are now so unpredictable and so erratic that you have to diversify, you have to have some gold, just in case things get out of hand.

Question: What about politics in the current situation?

Answer: My feeling is that if an election were held today, Reagan and the Republicans would be swept out of office. The unemployment situation alone would insure a Democratic sweep. And I'm not at all sure that unemployment is going to get any better by 1984. Thus, with Reagan's popularity currently at a new low, I am beginning to envision a Democratic victory across the board. The first item the Democrats will attack will be unemployment. They'll do it via make-work programs and even bigger spending. This will produce bigger deficits and more monetary inflation. This scenario, to my mind, is the single biggest plus for gold.

Question: What did you think of Reagan's State of the Union speech?

Answer: Personally, I thought it was a disaster. But let me include a quote from NY Times conservative columnist William Safire:

> **WASHINGTON, Jan. 26 — What a disappointment. The themeless pudding called this year's State of the Union address was a series of banalities intended to ingratiate the President with his political opposition; instead, this worst of Reagan speeches invited the grinning contempt it received.**
>
> **When the man whose political life has supposedly been dedicated to reducing the Government's domination of the economy spoke the words "We who are in government must take the lead in restoring the economy," the Democrats immediately caught the signal that Mr. Reagan had admitted failure and abandoned "ideology."**
>
> **On cue from the Speaker — who had seen the advance text and arranged the demonstration — they rose up with a derisive ovation and delightedly accepted the President's surrender. Tip O'Neill was quick to point out later that Mr. Reagan's new position was a far cry from "Government is not the solution" of yesteryear, and to hail the "historic reversal."**
>
> **That was the moment the Reagan Revolution lost its zip, and the saddest part was that the man reading the Teleprompter never did understand why he was getting such a big hand. Never before had a President, while trying to be nonpartisan, been so stingingly rebuffed.**

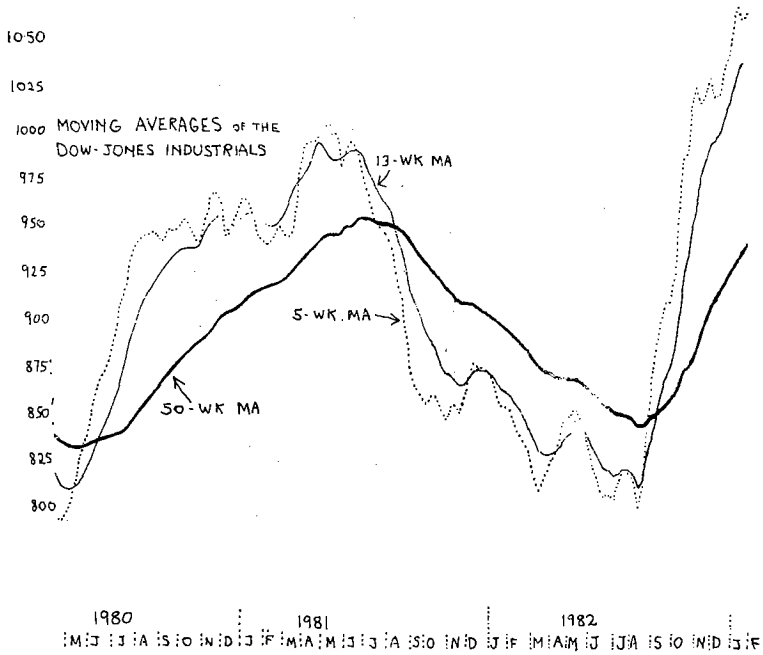
And here's the last paragraph from the January 27 WSJ editorial. Nuff said.

> **Of course, it is also possible and perhaps, we're sad to say, probable, that next year's State of the Union speech will be even more timid and resigned than this one and that by then we will have heard the last of Ronald Reagan's once-bold ideas for government reform. If that happens the Republicans can write off their chances for hanging onto the White House in 1984, and the nation can write off its chance of getting off the cycle of recession and inflation on this go-round.**

SIMPLE: One of my personal rules in life is "Keep it simple." I apply this rule to investments as well. A corollary of this rule is: "If you can't understand it, don't do it and don't buy it." Over the years, I've made a thorough study of investors and their losses, and in most cases I find that the underlying reason for the loss is that the investor bought a stock or a market he didn't understand.

So I go back to my principle, keep it simple. If you keep your investment procedures simple, then the chances are that you are going to operate successfully. Along these lines, one of the simplest and most effective techniques that I use to identify trends is based on the action of the three moving averages. Subscribers who have followed me for a few years know that I apply the moving average technique to (1) The Dow, (2) the PTI, (3) gold. In the construction of the moving averages, I use a method which is more sensitive than the standard moving average, and this results in what is termed the exponential moving average.

The moving average study is one that guarantees to put you on the right side of the market. Now there's always a catch in any market study, and the catch in the moving average study is that you may get whip-sawed. I try to avoid the whip-saw by concentrating on the major moving average signals, the signals given when the 13-week MA crosses above or below the 50-week MA. The more sensitive or minor signals are given when the 5-week MA crosses above or below the 13-week MA.



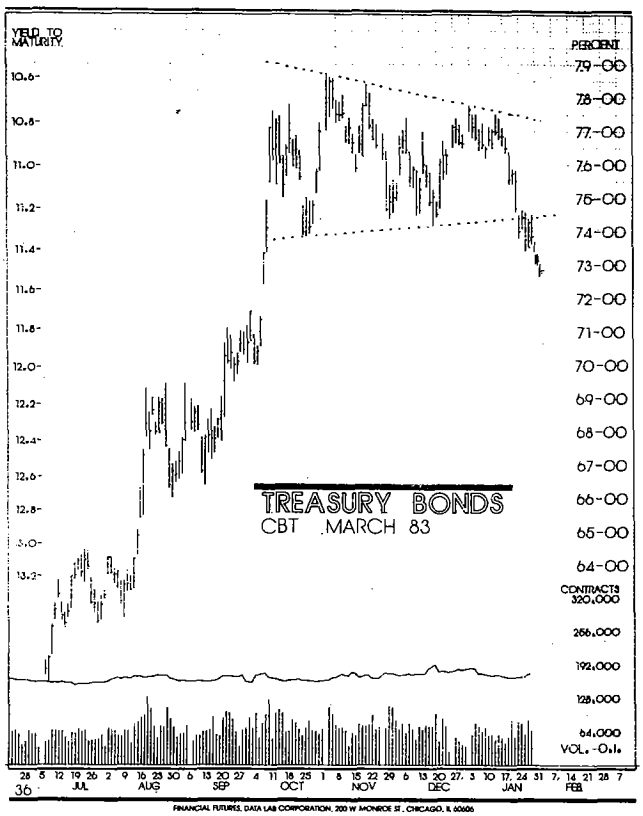
Note that since 1980 there have only been three major signals. The first major signal came on January 18, 1980 when the 13-week MA crossed above the 50-week MA. That buy signal was reversed on May 28, 1981 when the 13-week MA dropped under the 50-week MA. The most recent buy signal occurred on September 17 when the 13-week MA again rallied above the 50-week MA.

At present the mode of the three MA's remains bullish. Of particular interest is the fact that the 5-week MA has held above the 13-week MA ever since August 27. This is a long period for the 5-week MA to remain dominant. And for this reason it may be that when the 5-week MA finally falls below the 13-week MA we will have to lighten up. This will be doubly true if the PTI looks bearish at that time.

The 5-week MA now stands at 1062 while the 13-week MA is at 1041. For those who are anxious to take profits, this tells us that we still have time on our side. My feeling is that on a sensitive basis stocks may be held AT LEAST until the 5-week MA breaks below the 13-week MA and this has NOT yet occurred. For long-term investors, it would be well to hold stocks as long as the 13-week MA is above the 50-week MA (the 50-week MA of the Dow now stands at 949).

MONEY RATES: There's a real possibility that the deficits under President Reagan will, at the end of his four year term, equal the sum total of all the previous deficits in US history. Under those conditions, what possesses a man to buy a thirty year government bond (or any other kind of long-term bond, for that matter)? Perhaps it is confidence. Or as Lord Chesterton said of second marriages, "They are a triumph of hope over experience."

This chart of the March Treasury bond futures tells a grim story. We see the great rally from the July low to the November peak. At that point, the market started to discount the Reagan deficits and a top was formed. It's a massive top, actually extending from September to January. Last week the support for the structure



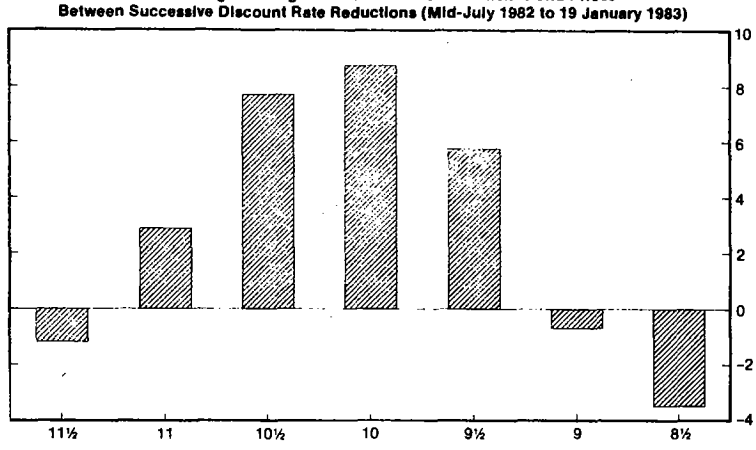
(at 74) was shattered, and the bond futures broke to within a fraction of 73. At that level, the yield on long-term T-bonds was roughly 11.5%

Thus, despite seven consecutive cuts in the discount rate (from 11.5% down to 8.5%) the bond markets are beginning to crack. This means higher interest rates and a potential new squeeze on an already struggling economy.

Meanwhile, the deficit picture has not been lost on gold. The ratio of gold to the Dow hit a low of 391 in mid-November. Since then the ratio has been climbing in favor of gold over the Dow. The gold/Dow ratio hit a high of 475 last week. The markets are saying that the preferred place to be is–in gold.

Has the Fed "shot its wad"? This chart (courtesy of Saloman Bros.) suggests that it has. Here we see that discount reductions are now bringing LOWER bond prices. Why? Obviously, from here on a lower discount rate simply intensifies fears of inflation–hence LOWER bond prices and HIGHER interest rates! Advice–get out of longer-term bonds.

Price Change in Long Bellwether U.S. Government Bond Prices Between Successive Discount Rate Reductions (Mid-July 1982 to 19 January 1983)



NOTES & QUOTES: I've admitted this before: I'm a newspaper and magazine nut. So add *USA Today,* the new "national newspaper" to my daily batch of newspapers. In case you want an update, here's a list of the papers I read each and every day. (1) *New York Times,* in my opinion, the world's best and most informative paper. Besides great news coverage, the "new" Times is chock full of special features, reviews, critiques. I skip the flaming liberal editorials, except for William Safire, who is tops. (2) *San Diego Union,* our much-maligned local paper. Really a pretty good product, and it boasts our very fine financial editor, Don Bauder. (3) *Los Angeles Times,* probably the best paper in the West, even though it's ugly and messy and black-inky. It's financial section is not as good as the San Diego paper, but it's entertainment section is the best in the nation. (4) *Wall Street Journal,* the great national business newspaper with the biggest daily circulation in the country–a must. (5) *Christian Science Monitor,* a fine national paper. CSM articles are original, well researched and concentrated. Excellent for international news. (6) *USA Today,* dubbed "McPaper" because of its short, one-paragraph articles and TV look. A new concept, a very sexy paper–lots of graphs and facts, big sports, human interest and entertainment coverage. I like it, and I'm guessing it's going to make it.

As for magazines, I must read forty magazines weekly or monthly. You never know when one magazine or another will have a great article, and some of the best articles will appear in such varied fare as New Yorker, New York Magazine, Smithsonian, Esquire, Fortune, Business Week, occasionally Time or Newsweek, Interview, W, Life, well, I could go on and on, and yes, occasionally Penthouse and Playboy will have an outstanding article. Most gorgeous trio, Town and Country, Geo, Life.

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Now it's coming to light: a theory I've harbored for years. There is a connection between cancer and emotions. I have always felt that cancer is the disease of "resignation." Researchers are now reporting that people who have trouble expressing their emotions, particularly under stressful conditions, possess the cancer personality. Evidently, the person who appears resigned to a problem, who can't cope with a stressful situation (and is therefore resigned to frustration) is the cancer-type. It seems that the "impossible predicament" can result in a breakdown in the immunity system, and the result can be cancer.

I take a religious view of all "insurmountable problem" situations. Here is my view: God never means to destroy anyone. If you find yourself in an "impossible" situation, then you're not seeing the situation correctly. No situation is impossible, although a situation may SEEM impossible. Usually the solution has to do with the person making a very courageous move, a move he ordinarily would not take. Never be resigned to a so-called impossible situation. There is always an *alternative*–always.

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Commodity prices are firming–and, believe me, just in time. The farms are in depression. You don't believe it–listen to these statistics. In 1973 farm income hit a record $33 billion. Last year, in 1982, US farm income dropped to $19 billion, $6 billion below 1981, $13 billion below 1979 and $14 billion below the 1973 peak!

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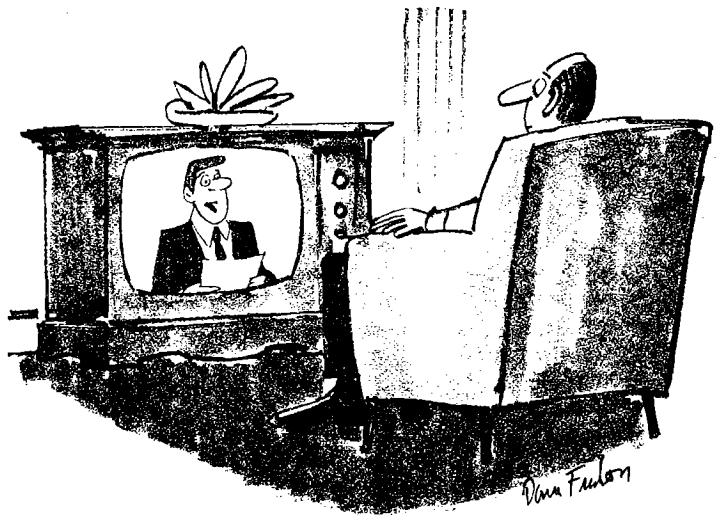
Great cartoonists have the ability to cut through the fog, the subterfuge, the nonsense–and show us things we knew–but were afraid to say out loud. Along those lines, I got a laugh out of this New Yorker cartoon.



"Last week, interest rates went down again, the Dow-Jones went up, inflation dropped, unemployment dropped, tension between the United States and the Soviet Union eased, our balance of payments stabilized, the gross national product grew very nicely, but still everything seemed to get worse."

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Maybe I'm nuts, I find myself personally angry at the action of the banks in making those insane foreign loans. What about the "prudent man rule"? Well, as they say, if you're going to goof, do it with billions, not millions. I thought this letter published in Time magazine was worth including here. . . .

> As a former deputy comptroller of the currency for special surveillance, I know that all national banks, large and small, were regularly informed of their excessive and risky loans to foreign countries. These loans were not made solely on the recommendation of young lending officers; they were approved by the banks' directors. The comptroller's attempts to reduce or eliminate these loans were thwarted by a Federal Reserve Board that contended that loans to foreign countries should not be criticized, and by bank executives who argued that such countries could not go bankrupt or fail to exist. In view of the current situation, the Fed and the bankers should remember that they were told that even in lower Manhattan the chickens would come home to roost.
>
> *Robert A. Mullin*
> *Rockport, Texas*

TIME, JANUARY 31, 1983

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Here's a second notice on the 1982 pages for the Dow Jones chart book and also for the advance-decline ratio chart book. Please send us your orders NOW as we will have to gauge the size of the printing. The pages cost $2 each, and they will be sent out within three weeks. In answer to many questions, I will not be printing the complete albums again, but I feel that the recent pages are informative enough so that most serious investors and market students will want to have them.

LATE NOTES: It's bad news you want? Easy, just pick up the nearest magazine, newspaper or turn on your radio or TV. But this stock market is obviously marching to a different tune. The market is watching the interest rates rising, it's watching Reagan waffling, it's watching business struggling, it's watching the money supply popping and it's watching the bad-loan accounts of the banks rise. And the market keeps climbing.

On February 4 the Transports closed at a record high of 485.07. That high was not confirmed by Industrials. Industrials will have to better 1092.35 to confirm–and they are at least pushing in that direction. The Transports were not the only good performers last week. On February 4 the D-J 65 Stock Average rose to a record high of 428.43. On February 4 my positive volume index rose to a new high as did the cumulative most-active stock index. Last but not least, the PTI hit a new high of 1485 on February 4, and the PTI is now just 25 points from its 1510 record high of June, 1981.

The steady rise in the PTI is telling us that the technical understructure of this market is strong. The tidal trend of stocks continues to rise. The bull would seem to need a rest–but he just wants to keep on snorting.

GOLD, SILVER: Technically, both metals are bullish. Gold above 500 has done everything a technician could hope it would do. As I stated in previous Letters, gold has pushed up above its head-and-shoulders bottom resistance level and the "count" or projection for gold is now in the 800 zone.

Although gold has rallied above major resistance at 500, it is still in the process of testing and re-testing 500. Once holding stubbornly above 500, gold should push higher and 500 should then act as a floor. The next major target for gold is 573, the halfway level between 850 (the old high) and 297 (the June, 1981 low). If gold can get above 573, it should mount an attack on the all-time high of 850.

The fundamentals for gold are now misty and exotic. With interest rates rising, the dollar has grown very strong again, and this could put renewed pressure (*deflationary* pressure) on the US economy. At the same time, higher interest rates would make it more expensive to hold gold, and this would normally be an adverse factor in the gold equation. Add to this the sliding price of oil (this too is deflationary) and we have quite a few negatives for both gold and silver.

On the plus side, sliding oil prices will put the oil producing nations under pressure and Mexico in particular would verge on bankruptcy in the event of a collapse in the price of oil. A cave-in by oil producing nations would also put the world's banking system in jeopardy and would require untold billions of dollars in emergency funds. In the face of this kind of crisis, gold could literally "go to the moon."

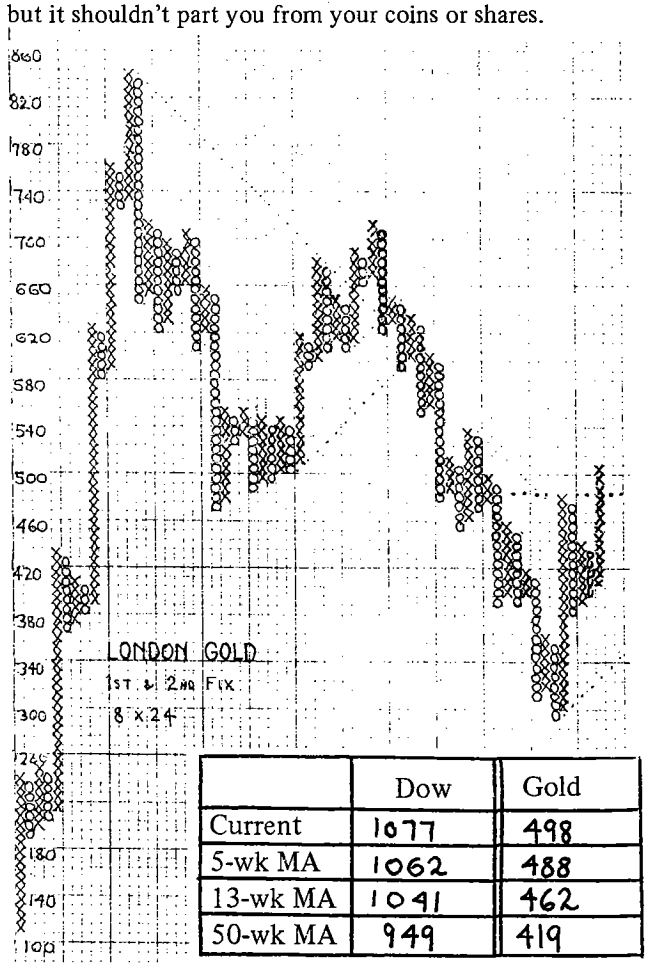
Finally, there is every probability that the US national debt will rise to $2 trillion by 1986, and there is no question in my mind that ultimately this debt will have to be repudiated in some way or another. If this happens, the worth of the dollar will be highly suspect, and gold will come into its own as the only real money.

For newer subscribers I should explain that all paper money is managed money (managed by the issuing nation). But the trouble with managed (fiat) money is that it is almost always mismanaged. In the final analysis, gold is the only money that is (1) international, (2) never questioned as to value, (3) not managed by any nation or central bank. Because gold is real money, because there is no danger of gold ever "going out of business", because of these reasons gold does not have to pay any interest. Gold pays no interest because there is no ultimate risk in holding it.

What do I mean by "ultimate risk." I mean that every paper currency in history has ultimately gone down the drain (the demise of a paper currency is simply a matter of TIMING). But gold is ALWAYS money–thus there is no ultimate risk in holding it (but there is a penalty, and that penalty is the loss of interest that one can receive in holding paper money–the riskier the paper money, the higher the interest the market demands).

I have been stressing the value and importance of the exponential moving averages in guaging the strength or weakness of gold. The latest figures are shown below and as you can see, gold remains bullish under the MA study. The Dow figures are also shown, and here too under the MA study the Dow remains bullish.

My long-term point & figures chart shows the breakout of gold, a breakout from a massive and impressive base. Gold continues to test and re-test that 495-500 level. So far, the gold rise has been plodding and halting. In due time, we should see more excitement in the metals. But don't be impatient. The market can out-wait 90% of the traders and investors–and it loves to do just that. As an aside, I feel that there are *too many* bulls in gold at this time. This could make for some erratic, shake-out type action. That would be hard on the holders of gold futures, but it shouldn't part you from your coins or shares.



	Dow	Gold
Current	1077	498
5-wk MA	1062	488
13-wk MA	1041	462
50-wk MA	949	419

NEXT MAILING: February 24